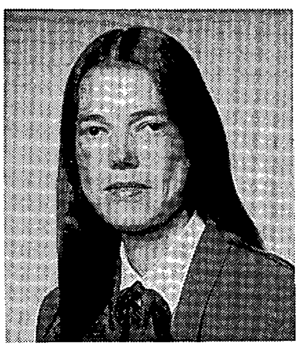
Loss Carryovers in Corporate Bankruptcy Reorganizations Under Prop. Reg. § 1.269-3(d)

Janet A. Meade and Janice E. McClellan examine the ramifications of the recently proposed regulation limiting or disallowing net operating losses



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Historically, the federal income tax law has provided some relief from taxation to companies that have filed for bankruptcy protection under Title 11 of the United States Code. One such relief provision is Code Section 382(l)(5), which exempts corporations in bankruptcy from the limitations of net operating loss carryovers as defined by Section 382. The recently proposed Reg. § 1.269-3(d), however, limits this exemption following an ownership change for which the principal purpose is tax evasion or avoidance. Although on the surface this proposed regulation is consistent with the overall thrust of Section 269, the effective application of the regulation would allow the Internal Revenue Service to severely limit or entirely disallow net operating loss carryovers for many corporations that reorganize after a bankruptcy. This article, therefore, examines the ramifications of the proposed regulation and provides guidance for corporations currently considering bankruptcy reorganizations.

Limitation on the Use of Loss Carryovers

Sections 382 and 269 prevent profitable corporations from purchasing the assets or stock of a corporation having loss carryovers primarily to acquire the loss corporation's tax attributes. Similarly, these sections also prevent a corporation having loss carryovers from acquiring the assets or stock of a profitable corporation primarily to enable it to use its loss carryovers. Under Section 382(a), if an ownership change occurs with respect to a loss corporation, the amount of the loss corporation's taxable income for a post-change year that may be offset by the pre-change net operating losses cannot exceed the Section 382 limitation. The Section 382 limitation for a post-change year generally is equal to the fair market value of the loss corporation's stock (including nonvoting preferred stock) immediately before the ownership change multiplied by the applicable long-term tax-exempt federal rate as published in the Internal Revenue Bulletin.[1] In general, an ownership change involves an increase of more than 50 percentage points in stock ownership by one or more 5 percent shareholders during the preceding three-year (or shorter) "testing" period.[2]

If the loss corporation does not continue to carry on as an active trade or business during the two-year period following the ownership change, Section 382(c) reduces the Section 382 limitation to the amount of certain built-in gains and any excess limitation carried over from prior years. As a result, in order for a loss corporation or its successor to claim its current year deductions and any of the loss carryovers from pre-change years, it must either continue the loss corporation's historic business or use a significant portion of the loss corporation's historic business assets in its business.

> ***Example (1).*** Corporation A is engaged in the manufacture of ceiling fans and has a net operating loss carryover from 1990 of \$1,000,000. On December 31, 1990, Individual X acquires all of the stock of Corporation A from Individual Y in a taxable transaction. Immediately before the acquisition, the fair market value of Corporation A's stock was \$3,500,000. In 1991, Corporation A continues to manufacture ceiling fans and earns taxable income of \$300,000. Assuming that the applicable long-term tax-exempt federal rate is 7 percent, the Section 382 loss limitation for 1991 is \$245,000 (\$3,500,000 value of stock × .07, the applicable long-term tax-exempt federal rate). This limitation is required under Section 382 because Individual X increased his/her ownership from zero to 100 percent during the testing period. Corporation A's taxable income for 1991, therefore, is \$55,000 (\$300,000 of taxable income – \$245,000 of allowable net operating loss carryover). The remaining \$755,000 of net operating loss (\$1,000,000 of net operating loss carryover from 1990 – \$245,000 of allowable net operating loss deduction for 1991) is carried over to 1992 and later years.

Exception for Corporations in Bankruptcy

Although Section 382 limits the amount of net operating loss carryovers that a loss corporation or its successor may deduct, special rules apply to corporations involved in bankruptcy reorganizations. Specifically, Section 382(l)(5) provides that the Section 382 limitation does not apply after an ownership change of a loss corporation if (1) the corporation is under the jurisdiction of a court in a Title 11 or similar case immediately before the ownership change and (2) the corporation's pre-change shareholders and qualified creditors own at least 50 percent of the value and voting power of the loss corporation's stock immediately after the ownership change. Notice that to qualify for the bankruptcy exception, the voting power of the stock owned after the ownership change is the critical factor, whereas under the general Section 382 rule both voting and nonvoting stock are considered.

While the primary benefit of the bankruptcy exception is to permit a loss corporation to escape the Section 382 limitation, two reductions in the amount of the net operating loss carryover are still required. First, the net operating loss carryover must be reduced by recent interest payments or accruals on creditor debt when such interest or accruals are converted to stock as part of the bankruptcy reorganization. This reduction is for any interest payment or accrual during the three taxable years preceding the year in which the ownership change occurs, as well as for that part of the ownership change year ending on the change date.

Second, the net operating loss carryover must be reduced by 50 percent of the excess of discharged debt over the value of the stock distributed to creditors. For purposes of this rule, stock transferred to a creditor is taken into account only to the extent that the stock is conveyed in satisfaction of indebtedness. Moreover,

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[1] IRC Sec. 382(b)(1) and (f). The long-term tax-exempt federal rate is the highest of the federal long-term rates in effect during the three preceding calendar months before the stock change.

[2] IRC Sec. 382(g) and (i). Under two special situations, the use of a testing period of less than three years is permitted. These situations involve either a recent ownership change or the occurrence of all losses after the beginning of the three-year period.

this indebtedness must either have been held by the creditor at least 18 months before the date of the bankruptcy filing or have arisen in the ordinary course of the corporation's business and have been held by the same person who at all times held the beneficial interest in the indebtedness.

> *Example (2).* On March 15, 1991, Corporation B files for protection under Title 11 of the United States Code. At the time of the filing, Corporation B owed creditors $1,000,000 plus interest accrued over the prior two years of $200,000. Prior to the filing, Corporation B had a net operating loss carryover of $3,000,000. Under the plan of reorganization, Corporation B exchanges its own common stock, valued at $500,000, to its creditors in satisfaction of the $1,000,000 debt and $200,000 of accrued interest. After the exchange, Corporation B's former shareholders and creditors own 100 percent of the corporation's outstanding common stock. As required by Section 382(l)(5), Corporation B's net operating loss carryover is reduced to $2,550,000 ($3,000,000 of net operating loss carryover – $200,000 of accrued interest – $500,000 of excess debt relief × 50 percent). The remaining $450,000 of net operating loss carryover is permanently disallowed.

In addition to the preceding two reductions in the amount of a loss corporation's net operating loss carryover, Section 382(l)(5) also stipulates that if a second ownership change occurs within two years after a bankruptcy-protected ownership change, the Section 382 limitation for any post-change year becomes zero. The effect of this requirement, therefore, is to disallow the use of any net operating loss carryover and to eliminate the "value" that was created when debt was capitalized by the cancellation or exchange for equity in the bankruptcy reorganization.

Application of the special exception for corporations involved in bankruptcy reorganizations is not mandatory. As a result, a loss corporation or its successor may elect to be excluded from the rules of Section 382(l)(5). Such an election would be beneficial, for instance, in situations where the interest payments and accruals plus 50 percent of the discharged indebtedness entirely eliminate the net operating loss carryover. When a corporation elects out of Section 382(l)(5), Section 382(l)(6) requires that the Section 382 limitation be computed on the basis of the value of the corporation immediately after the ownership change, rather than before it. Accordingly, this provision effectively increases the amount of the allowable net operating loss carryover over what it otherwise would have been under the general Section 382 limitation since the value of the corporation after the ownership change reflects the surrender or cancellation of the creditors' claims.

Prop. Reg. § 1.269-3(d)

Irrespective of Section 382, Section 269 can be utilized by the IRS to disallow the carryover of net operating losses where a corporate acquisition takes place in which (1) control of the corporation is secured and (2) the principal purpose of the acquisition is the evasion or avoidance of federal income tax. In general, Section 269 stipulates that if a taxpayer acquires property of another corporation primarily to evade or avoid federal income tax by securing the benefit of a deduction, credit, or other allowance that the acquirer would not otherwise enjoy, the deduction, credit, or other allowance will be disallowed. Moreover, Section 269 may be applied to disallow a net operating loss carryover even though such carryover is limited pursuant to Section 382.

For purposes of Section 269, control is secured when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. Creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) secure control of a corporation when they acquire beneficial ownership of the requisite amount of stock. However, they are treated as acquiring beneficial ownership no earlier than the time a bankruptcy court confirms a plan of reorganization.[3]

Prop. Reg. § 1.269-3(d) takes Section 269 one step further by directing the disallowance rule to corporations involved in bankruptcy reorganizations. Specifically, this proposed regulation states:

> Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which Section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the Title 11 or similar case. The determination of whether the corporation carries on more than an

[3] Prop. Reg. § 1.269-5.

insignificant amount of an active trade or business is based on all the facts and circumstances. These facts and circumstances may include, for example, the amount of business assets that continue to be used or the number of employees in the work force who continue employment. Where the corporation continues to utilize a significant amount of the historic business assets or work force, however, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease.[4]

The proposed regulation further stipulates that even if a bankruptcy court determines that a plan of reorganization under Title 11 is not primarily undertaken with the intent to evade or avoid federal income tax, the regulation can still apply. The presumptive position of the proposed regulation, therefore, is especially strong since a court ruling as to the motive of the transaction is not controlling.

Justification for the IRS's position in Prop. Reg. § 1.269-3(d) rests on the argument that the potential for tax evasion or avoidance via Section 382 is greater in a bankruptcy reorganization than in other forms of reorganization because fewer limitations are imposed on the carryover of net operating losses. The concern of the IRS is that corporations not planning to carry on significant business may reorganize under Title 11 for the sole purpose of falling under the Section 382(l)(5) bankruptcy exception. As such, these corporations would be allowed to preserve their net operating loss carryovers and, in so doing, to provide their creditors with an opportunity to recoup their losses, in part, through the tax system. The position of the IRS, therefore, is that since the principal purpose of these types of reorganization is for the evasion or avoidance of tax, none of the net operating losses incurred prior to the reorganization should be allowed as a carryover.

Although on the surface the position expressed by the IRS in Prop. Reg. § 1.269-3(d) is consistent with the overall thrust of Section 269, the regulation essentially allows the IRS to severely limit or entirely disallow net operating loss carryovers for many corporations that reorganize after a bankruptcy. As an example, a corporation may scale down its operations under a bankruptcy reorganization to a point where the IRS considers the current operation to be insignificant relative to the corporation's prior operation. In such a situation, any taxable income generated by the corporation could not be offset by pre-change net operating loss carryovers because of the proposed regulation.

Example (3). Corporation C is a manufacturing company generating gross revenue of $500,000 per month. Over the last three years, the corporation has incurred net operating losses for tax purposes of $6,000,000 and has accumulated $4,000,000 of debt. Due to this heavy debt load, the Board of Directors of the corporation has filed for protection under Title 11 of the United States Code. The plan of reorganization, approved by the bankruptcy court, provides for the creditors of Corporation C to receive 50 percent of the company's outstanding stock, worth $2,000,000, in exchange for relief of all debt. In addition, the plan calls for Corporation C to scale down its work force by 60 percent and auction off 50 percent of the plant equipment. Corporation C has complied with this plan and, under the scaled-down operation, now generates $200,000 per month in gross revenue. Moreover, due to the reduction in operating cost, the corporation is now earning approximately $20,000 per month ($240,000 annually) of taxable income. Under Section 382(l)(5), $5,000,000 of pre-change net operating losses ($6,000,000 of net operating losses incurred prior to the reorganization − $2,000,000 of excess debt relief × 50 percent) can be carried over and used to offset taxable income. This allowance will relieve Corporation C of all current tax liability. However, due to the drastic reduction in work force and historic assets used in the business, the IRS may consider the current operation to be insignificant in relationship to the prior operation and apply Prop. Reg. § 1.269-3(d). Should the IRS take this position, none of the pre-change net operating losses would be allowed as a carryover, resulting in a current tax liability to Corporation C of $76,850.

Planning Considerations

The IRS has stated that it will not issue any rulings or determination letters with respect to whether an acquisition is within the scope of Section 269.[5] As a result, taxpayers are placed in the position of having to make their own interpretations and, in many cases, set their own guidelines regarding the application of this statute. For corporations facing the disallowance rule of Prop. Reg. § 1.269-3(d), the central consideration is the definition of an insignificant amount of active trade or business. The proposed regulation merely states that all

[4] Prop. Reg. § 1.269-3(d), 55 *Fed. Reg.* 33139 (Aug. 14, 1990).
[5] Rev. Proc. 89-3, 1989-1 CB 761.

facts and circumstances will be taken into account in the determination of "insignificant" activity. The only guidance provided by the regulation is a reference to the continued use of historic assets and employment of the work force after the reorganization. Absent more specific guidance, therefore, taxpayers may wish to look to other Code sections and court decisions to gain insight as to how the term "insignificant active trade or business" might be applied.

Section 368 specifies seven corporate reorganizations that qualify as nontaxable exchanges. Among one of the general requirements of this statute, as delineated in Reg. § 1.368-1(d), is that a significant portion of an acquired corporation's assets be used by an acquiring corporation in order to maintain business continuity. Reg. § 1.368-1(d)(4)(iii) further states that the portion of a corporation's assets which generally will be considered "significant" will be based on the relative importance of the assets to the operation of the business. However, this definition of significance is again based on all the facts and circumstances.

A better guide might be the definition of "substantially all" as used in the determination of business continuity after a corporate reorganization. Under Section 368, one of the basic rules of the business continuity test is that an acquiring corporation use substantially all of the business assets of the acquired corporation. Employing these rules as a guideline, a taxpayer could argue that if substantially all of the business assets of a corporation are being used after the corporation has filed for protection under Title 11, then the corporation is operating more than an insignificant amount of an active trade or business. This use of assets consequently would cause Prop. Reg. § 1.269-3(d) to be inapplicable.

Although the Code does not specifically define the phrase "substantially all," the IRS has stated in Rev. Proc. 77-37[6] that this phrase requires an acquiring corporation to retain at least 90 percent of the fair market value of the acquired corporation's net assets and at least 70 percent of the fair market value of the acquired corporation's gross assets. Based on this definition, a taxpayer consequently could assert that a corporation reorganizing after a bankruptcy is carrying on more than an insignificant amount of an active trade or business if it continues using at least 90 percent of the fair market value of the net assets plus 70 percent of the fair market value of the gross assets of the loss corporation.

In comparison to the IRS's definition, the judicial interpretation of the phrase "substantially all" has been more lenient. For example, the Fifth Circuit Court of Appeals held in *Smothers*[7] that the transfer of 15 percent of a corporation's net assets to another corporation satisfied the "substantially all" test. In this case, the assets transferred were the total operating assets; the remaining 85 percent were liquid assets distributed to the shareholders in liquidation of the transferor corporation. The court, therefore, determined that since all of the assets necessary to operate the business were transferred, the transaction qualified as a reorganization of a continuing business.

Similarly, in *Moffatt*[8] and *Viereck*[9] the courts held that transfers of 65 and 20 percent, respectively, of the total corporate assets satisfied the "substantially all" test because these assets constituted all of the essential operating assets. The retention of nonoperating assets did not enter into the courts' determination since these consisted of cash, notes, land, and various intangibles that were not required for the continuing operation of the businesses.

Based on these and similar judicial interpretations, corporations involved in bankruptcy reorganizations would appear to be carrying on more than an insignificant amount of an active trade or business if at least 90 percent of the historic operating assets continued to be used in the business after the reorganization. Moreover, any transfer of a loss corporation's liquid assets to creditors should not invalidate the reorganization for purposes of the bankruptcy exception under Section 382(l)(5) since these assets would not be required for the active continuation of the business.

To avoid the entire issue of whether a corporation reorganizing under Title 11 is carrying on more than an insignificant amount of an active trade or business, a reorganization could be structured so that debt is not exchanged for stock. This form of reorganization would preserve the ownership structure and, in so doing, bypass the uncertainty created by Prop. Reg. § 1.269-3(d) when creditors become stockholders. In such a situation, however, any new funds would have to be attracted by giving the post-change equity owners no more than 50 percent of the stock and voting power of the reorganized corporation since the shareholders of

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[6] Rev. Proc. 77-37, 1977-2 CB 568, in which the IRS defines the "substantially all" test as required by IRC Secs. 354(b)(1)(A), 368(a)(1)(C), 368(a)(2)(B)(i), 368(a)(2)(D), and 368(a)(2)(E)(i).

[7] *J.E. Smothers v. U.S.*, 81-1 USTC ¶ 9368, 642 F.2d 894 (CA-5), aff'g 79-1 USTC ¶ 9216 (S.D. Tex.).

[8] *J.G. Moffat v. Com.*, 66-2 USTC ¶ 9498, 363 F.2d 262 (CA-9), aff'g CCH Dec. 26,842, 42 TC 558 (1964).

[9] *L.F. Viereck v. U.S.*, 83-2 USTC ¶ 9664, 3 Cl. Ct. 745.

the loss corporation must maintain the remaining 50 percent.

Another option to avoid Prop. Reg. § 1.269-3(d) would be for the loss corporation to elect out of the bankruptcy exception. Such an election might be beneficial in situations were the corporate creditors are forgiving a large amount of debt in exchange for a small amount of stock. In these cases, the bankruptcy exception results in a large reduction in tax attributes, usually net operating loss carryovers. Accordingly, because the general Section 382 rule does not reduce the total net operating loss carryovers, but rather the amount of their annual use, the corporation would still benefit from the entire carryover. The tax benefit, however, would come over a longer period of time.[10]

Finally, taxpayers facing the threat of Prop. Reg. § 1.269-3(d) may wish to consider whether the regulation reflects the congressional intent of Section 382(l)(5) and, thus, whether it could be upheld in court. With the enactment of Section 382(l)(5), Congress specifically expressed a desire to provide relief to corporations reorganizing under Title 11 by exempting them from the Section 382 limitation. As such, the statute clearly stipulates the tax results of bankruptcy reorganizations in which creditors receive stock for debt. Any tax benefit received by the creditors, therefore, seems immune to disallowance under Section 269 because Congress intended to grant the benefit. The application of Section 269 and, particularly, Prop. Reg. § 1.269-3(d) consequently may be inappropriate.

Conclusion

Prop. Reg. § 1.269-3(d) states that where a corporation undergoes an ownership change pursuant to a plan of reorganization under Title 11 of the United States Code, the carryover of the corporation's net operating losses may be disallowed if the reorganization is determined by the IRS to have been made primarily for the purpose of tax evasion or avoidance. Although this proposed regulation may never be adopted, it nevertheless presents taxpayers with considerable uncertainty regarding bankruptcy reorganizations to which the carryover rules of Section 382(l)(5) apply. In particular, the proposed regulation appears to impose a continuity-of-business requirement on loss corporations without accounting for circumstances under which the continuation of business may not be possible. Careful tax analysis, therefore, is warranted until such time as the IRS provides additional guidance. ■

[10] For a discussion regarding election out or noncompliance with the bankruptcy exception, see R. E. Halperin, "Planning for Loss Carryovers Under Section 382 When a Corporation Is Insolvent," 71 *The Journal of Taxation* 150 (September 1989), at 153.

Factors to Determine "Religious Order" Qualifications

Remuneration received for services performed by a member of a religious order in the exercise of duties required by the order is generally exempted from liability for self-employment and withholding taxes. The following guidelines set forth by the IRS will apply in all situations determining an organization's and member's qualifications as and in a religious order: (1) the organization qualifies under Code Section 501(c)(3); (2) members vow to live under a strict set of rules requiring moral and spiritual self-sacrifice and dedication to the organization's goals at the expense of their material well-being; (3) members make a long-term commitment to the organization; (4) the organization is controlled and supervised, or is significantly funded, by a church or convention or association of churches; (5) members normally live together as part of a community and are subject to a stricter level of moral and religious discipline than that required of lay church members; (6) members work full time on behalf of the organization's religious, educational, or charitable goals; and (7) members participate regularly in such activities as prayer, religious study, care of the aging, missionary work, or church reform or renewal. — Rev. Proc. 91-20, I.R.B. 1991-10, CCH STANDARD FEDERAL TAX REPORTER, ¶ 46,215.